Nestor A Espenilla, Jr: Mindfulness and vigilance

Keynote speech by Mr Nestor A Espenilla, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the Money Market Association of the Philippines, Inc. (MART) MART First General Assembly, Makati City, 22 March 2018.

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Good evening everyone. I thank the officers and members of the Money Market Association of the Philippines, Inc. (MART) led by Mr. Christopher Salazar for the invitation to speak today about the current operating environment, the BSP's monetary policy actions ... our direction ... and our mindful approach in the implementation of monetary, prudential and financial reforms.

Mindfulness. The concept of "mindfulness" has gained so much popularity. It is a buzz word that frequently crops up in online articles, magazines, newspapers, TV programs, podcasts and conversations. But what does it mean? Does "mindfulness" have application in Central Banking and monetary policy formulation? I believe so.

"Mindfulness" is not a new idea. The concept is core to Buddhism, traced as far back as the fifth century BC. A widely used definition is by Dr. Jon Kabat-Zinn of the University of Massachusetts Medical School. He defines mindfulness as "paying attention in a particular way: on purpose, in the present moment and non-judgmentally."

What is monetary policy's "present moment"?

Monetary policy stance

Just this afternoon, in our latest monetary policy assessment, the BSP maintained its key policy rate steady at 3.0 percent for the overnight borrowing or reverse repurchase (RRP) facility. Corresponding rates on overnight and deposit facilities were also kept unchanged.

Our decision is based on our assessment that while recent inflation outturns show elevated path in 2018, latest baseline forecasts continue to show inflation remaining within the target in 2018 and moderating further in 2019. We also considered that prospects for domestic activity continue to be firm on the back of robust domestic demand, strong growth in credit and liquidity, and sustained recovery in global economic growth.

As such, monetary policy action is not warranted at this time, at this present moment.

Vigilance

Tsong-kha-pa, a famous Teacher of Tibetan-Buddhism, wrote in his Great Treatise on the Stages of Path to Enlightenment, that mindfulness is a non-distracted focal attention on the present. Vigilance, on the other hand, is the close monitoring of that very awareness.

Practicing vigilance, we at the BSP, note that inflation expectations have started to rise and will therefore need to be closely monitored in the coming months. Remaining watchful, we acknowledge that on balance, risks to the inflation outlook remain weighted toward the upside. With circumspection, we observe that there are potential second round price pressures emanating from pending petitions for adjustments in minimum wages and transportation fares. Nevertheless, non-monetary measures, such as targeted subsidies, are expected to mitigate these inflationary impulses. Proposed tariffication reforms in the rice industry could also positively surprise and help significantly temper price pressures especially in 2019.

Looking ahead, we stay alert to any signs of second-round effects and inflation becoming broader based. We stand firm in our intent to take immediate and appropriate measures to ensure that the monetary policy stance supports our price and financial stability objectives. Economic growth remains solid enough to absorb some policy tightening if warranted. Further, we observe that market mechanisms are working well to enable the economy to automatically adjust to fluid conditions efficiently and avoid serious imbalances, as well as overheating risks.

Our decisions on the monetary policy stance will continue to be data-dependent. Focus will be on domestic conditions while taking into account external developments only to the extent that these impact the domestic inflation outlook and financial conditions.

Need for vigilance in face of risks

Why is vigilance important? English writer J.A. Baker, in his work, "The Peregrine: The Hill of Summer Diaries" wrote that, "Binoculars, and a hawk-like vigilance, reduce the disadvantage of myopic human vision."

We cannot afford myopia. We must always be mindful of the risks all around us.

World economic activity finally started to gather speed after years of subpar growth following the Global Financial Crisis. The IMF revised its global growth forecasts for 2018 and 2019 to 3.9 percent, 20 basis points higher than the previous forecast.

At the heart of external risks is the US Federal Reserve's normalization of its monetary policy. Further, other major central banks are also considering exit from expansionary monetary policy. Geopolitical tensions and rising protectionist sentiments further complicate the global operating environment.

Zen in the resent: strength of the economy

The existence of risks is not a negative thing. Risks will always be present. The good news is that the present reality imbibes confidence in us.

The Philippine economy is strong. We continue to deliver gains amidst monetary policy divergence and uncertainty. Our macroeconomic fundamentals are robust and sound. Further, our financial system is more sophisticated, disciplined, and resilient.

Real GDP has registered positive growth for 76 consecutive quarters, covering a span of 19 years since 1999! In 2017, GDP grew by 6.7 percent, making the Philippines one of Asia's fastest and most consistently growing economies.

This growth performance is in line with the economy's potential output, currently estimated at around 6.0-7.0 percent. The improvement in potential output reflects declining incremental capital-output ratio, rising total factor productivity, and improving workforce capacity. As we pour in more investments in physical infrastructure under Build, Build, Build, and more soft investments in our young population to provide better health, high quality education, and skills development, we can expect further accelerated growth in potential output. These investments are sustainable because they are supported by a prudent fiscal position characterized by lower National Government debt-to-GDP ratio of around 42 percent and additional revenues to be generated from the recent tax reform (TRAIN).

There is thus strong basis for asserting that the economy can sustain its growth momentum. Likewise, higher output capacity should allay concerns of potential overheating.

The country's external position is manageable despite global headwinds. The country's overall balance of payments (BOP) for the year 2017 posted a deficit of US$863 million. This is just 0.3% of GDP. The underlying widening of the trade-in-goods gap stems from rising imports of goods that support domestic capital formation and production. This development is consistent with the country's growth narrative. One should expect that the economy's expansion will be accompanied by stronger demand for imports. Over time, investment led economic activities will support needed infrastructure development, raise domestic competitiveness, increase goods exports, and alleviate the trade gap.

The sustained resilience of foreign direct investments, overseas Filipino (OF) remittances, and business process outsourcing (BPO) receipts provide additional buffers to the domestic economy. External debt metrics have also improved as reflected in the continued decline in the external debt-to-GDP ratio to around 23 percent. Gross international reserves (GIR) of US$80.6 billion as of end-February 2018 provide ample manoeuvring room to manage shocks.

The Philippines' robust economic growth has been accompanied by manageable inflation. We have established since 2009 a solid track record of meeting our inflation targets.

Headline inflation's year-to-date average rose to 3.7 percent (using the 2012 series) in 2018. This is at the high end of the target range of 3.0 percent ± 1.0 percentage point in 2018. But we expect it to revert to the target midpoint in 2019.

The Philippine banking system remains safe and sound, with robust performance and sustained expansion in credit. This is complemented by improved asset quality, firm liquidity position, and strong capitalization.

The road to a resilient banking sector has not been easy. Systematic structural reforms were implemented to get the financial system to where it is now. We have seen significant progress in the adoption of Basel III reforms, particularly in the areas of capital, leverage, liquidity and regulation of systemically important banks.

We have rolled out a four-phased program for liquidity risk management. We continue to upgrade our corporate governance and risk management standards and remain committed to pursue prudential reforms amid changing market conditions and increasing sophistication of financial services.

Today, our comprehensive risk-based supervision approach ensures that our banks operate in a safe and sound manner. We use a range of tools and techniques in deploying our supervisory resources on a proportionate basis, including deployment of calibrated enforcement actions.

Indeed, our financial system demonstrates discipline and sophistication. It operates in a regulatory environment that promotes innovation. At the same time, it provides mechanisms to correct misbehaviour. This, together with strong economic foundation, affords us more confidence to forge ahead with bold market-oriented reforms and liberalization efforts. This will allow financial institutions to seize more opportunities to support our growing economy; to be more innovative, competitive and flexible and to adjust rapidly to the needs of their customers.

We recognize that transformative reforms are needed to gear up the financial system to be more efficient and responsive to the changing economic landscape.

Taking the next (confident) steps – expanding policy toolkit and bold financial reforms

As challenges evolve globally and domestically, the BSP continues to expand its policy toolkit, including enhancing price discovery and self-correcting mechanisms.

As early as 2016, we have committed to a more progressive and market-oriented framework with the operational shift in our monetary operations to the interest rate corridor (IRC) system.

Since then, we have seen the success of the IRC as an effective liquidity management tool. This is evident in the substantial migration of placements in the overnight deposit facility (ODF) to the

Term Deposit Auction Facility (TDF). It has allowed us to provide more effective guidance to short-term market interest rates by promoting healthy price discovery as the BSP calibrates auction volumes.

Indeed, for the past months, market rates have seen a stronger anchoring to the BSP's policy rate. Universal/commercial banks' time deposit and short term interest rates have trended upwards, aligning with BSP's IRC.

The effective implementation of the IRC now provides the BSP sufficient flexibility to increase reliance on market-based instruments for liquidity management.

As a result, we were able to initiate another major financial market reform: the phased and gradual reduction of the reserve requirement ratio (RRR), to allow for more efficient absorption and mobilization of liquidity, starting with a one percentage point reduction effective last March 2, 2018.

As with the shift to the IRC system, the phased reduction in reserve requirements is an operational adjustment and will not materially affect prevailing monetary policy settings. Excess liquidity released to the market will be re-absorbed through offsetting adjustments in our open market operations (OMO) that are informed by our updated liquidity forecasts.

Initial evidence based on the last three TDF auctions since the first RRR cut took effect are encouraging and indicative of the potency of the IRC facilities for liquidity absorption. We can definitely do more as the system continues to mature.

Ultimately, the BSP has many options to maintain firm monetary control. Shifts in monetary policy stance will continue to be signalled through changes in the policy rate. But we can also adjust monetary conditions without necessarily changing the policy rate, by adjusting auction volumes to move the market-determined TDF rates.

A flexible exchange rate is another integral part of our policy toolkit to maintain monetary stability and to ensure the sustainability of the balance of payments. We do not target an exchange rate level but we carefully watch out for excessive volatility that can disrupt the economy. Our ideal is a market-determined exchange rate that offers no persistent one-way bets to anyone.

Mindful of the potential build-up of systemic vulnerabilities, we have also deployed and continue to develop various macroprudential measures. Currently, we have exposure drafts on the countercyclical capital buffer, the debt-to-earnings borrowers test (DEBT) that is akin to the existing real estate stress test (REST), and the borrowers interconnectedness index.

Furthermore, we continue to enhance our surveillance tools. We are also exploring new technologies such as big data analytics to further improve our surveillance.

Finally, we are reinforcing our model-based assessments with qualitative and expert judgments on current macroeconomic and financial conditions.

Other game-changing financial sector reforms

Part of our transformative policy reform agenda is to accelerate financial market development. We give particular focus to foreign exchange (FX) and local currency debt markets. We envision a more balanced financial ecosystem where the banking system is complemented by a deep and liquid debt market.

Our bold financial sector reform agenda includes ambitious FX reforms toward a more organized FX market that supports a flexible and market-determined exchange rate. This includes further liberalizing FX rules to reduce the cost of doing business and to improve data capture.

In addition, we will enhance governance and oversight over the FX markets, including the USD/PHP market. This will further improve transparency, price discovery, and market conduct. We are currently drafting the governance framework for FX markets with a set of general principles that shall apply not only to the existing USD/PHP market, but also to any third currency/PHP market that may be established in the future. We have initiated engagement with the industry so that existing trading markets can conform to the new framework within a mutually agreed timeframe.

As you know, the BSP is also collaborating closely with other government agencies and industry associations such as MART, to implement the Philippine local currency debt market development roadmap. Immediate focus is on deepening liquidity, enhancing price discovery and strengthening regulatory oversight.

Recently, the Bureau of the Treasury released the implementing guidelines for the enhanced Government Securities Eligible Dealers (GSED) Program outlining incentives and accountability of market-makers. We count on your continued support in this endeavour, including providing effective two-way quotes to support market liquidity.

Even as we move towards further liberalization and increased market incentives, we likewise expect responsible behavior among market players, by adhering to market standards and rules in order to protect the integrity of the financial markets. We have a collective responsibility to consistently build our markets to rise above the craving for short-term gains.

Conclusion

Indeed, maintaining mindfulness and practicing vigilance will allow us to manage risks. And even beyond this task of risk management, we are positive that our favorable fundamentals and ample policy tools give us the confidence to pursue proactive and bold financial sector reforms towards a more efficient, flexible, and market-oriented environment.

As I close, I leave you with a principle that guides us in the BSP as we fulfil our mandates:

With mindfulness, we are aware of the present moment, but with vigilance, we are alert and watchful at all times.

It is a good principle to live by, whether in central banking or in all other concerns of life. Thank you and mabuhay!